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THE UNITED STATES TRADE REPRESENTATIVE
WASHINGTON
20506

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September 5, 1986

MEMORANDUM

To: Economic Policy Committee

From: Ambassador Yeutter [signature]

Subject: Japan Tobacco Section 301 Case

Summary

The TPRG recommends that the EPC recommend to the President that he determine that: (1) certain current Japanese practices concerning manufactured tobacco products are unfair within the meaning of Section 301, and (2) the U.S. will retaliate if Japan does not remedy these practices by October 6 (the date the President is statutorily required to decide what action, if any, to take). The TPRG also recommends that instead of assigning a value to the retaliation at this time, the EPC authorize the Section 301 Committee to continue to work on retaliation methodology and value. The next round of negotiations will take place September 8 and 9. If we resolve these issues in our negotiations with the Japanese before September 15, we will recommend that the President accept the resulting agreement.

Status of Case

The Trade Representative's non-public recommendation to the President is due September 15; the President must decide within 21 days thereafter (October 6) what action, if any, to take. The President's determination (including the reasons for it) must be published in the Federal Register.

We met with the Japanese in Hawaii and Tokyo earlier this month, and in Washington August 28 and 29. They are scheduled to return September 8 and 9. While we made some progress on various impediments to distribution of American cigarettes in Japan, the Japanese have been intransigent on the major issue--the barrier to access caused by the combination of a manufacturing monopoly and a high effective tariff.

Background

In the TPRG all agencies except CEA support an unfairness determination. The TPRG concluded that four aspects of Japan's

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practices were unfair within the meaning of Section 301. Viewed together, these practices appear designed to insulate an inefficient manufacturing monopoly from competition and to shift the costs of maintaining an uncompetitive domestic tobacco leaf industry from the Japanese treasury to imports and Japanese consumers.

1. Tariff, Tax and Monopoly

Japan's 20% tariff (ad valorem equivalent) compounded by a high, largely ad valorem excise tax imposes a severe price premium on imported cigarettes compared to Japanese domestic brands. Although tariffs and excise taxes on cigarettes are not unusual or unreasonable in themselves (we have both), and many countries have a manufacturing monopoly, Japan is the only industrialized country that has all three. All industrialized countries except Japan provide foreign cigarette producers the alternative to manufacture locally (or, in the EC, to ship duty free within the customs union); Justice notes that U.S. cigarette producers are unenthusiastic about local manufacture in Japan. Japan prohibits cigarette manufacturing except by its domestic monopoly. So, foreign firms have no means to avoid the tariff/tax barrier.

The TPRG, with CEA and OMB dissenting, believes the combination of a significant trade barrier (the tariff and tax) and an absolute investment barrier is unreasonable within the meaning of Section 301. OMB believes that we should not retaliate under Section 301 against mutually agreed, GATT-legal tariffs under any circumstances.

2. Excise Tax Payment Deferral

Japan currently provides its tobacco monopoly (JTI) with an extended grace period--six months now and three months in 1987--on the payment of excise taxes. In 1988, the period will become roughly the same as that for imports, one month. This extended tax deferral, which the Japanese admit is discriminatory, confers a benefit of between $130 and $150 million on JTI according to the U.S. industry.

The TPRG believes the deferral is an unjustifiable and discriminatory policy within the meaning of Section 301. CEA notes that the discrimination will end by 1988.

3. Price Approval System

All changes in cigarette prices in Japan must be submitted sixty days in advance of the proposed effective date to the Ministry of Finance (MOF) for approval. The actual period for a change to take effect can stretch up to five months due to additional requirements imposed by the monopoly-owned distributor, Tobacco Haiso. Although MOF has never rejected a price change request, it refuses to shift to a simple notification system, since it maintains the need to prevent "unduly low prices."

The TPRG, with Justice dissenting, believes this system is unreasonable within the meaning of Section 301. All agencies conceded that this was not a major issue.

4. <u>Distribution</u>

A subsidiary of the Japanese tobacco monopoly discriminates against imported cigarettes with respect to their distribution. We have made progress on most of these issues, and the TPRG assumes the remaining problems can be resolved. If they cannot, though, all agencies believe they could be called discriminatory or unreasonable within the meaning of Section 301.

<u>Retaliation</u>

The TPRG, CEA dissenting, recommends that the President determine to retaliate in principle and direct the Trade Representative to develop the retaliation list. In the interim the TPRG believes the Section 301 Committee should continue its work on methodology for, and value of, retaliation. We would inform the Japanese that a determination had been made, but that it would not be made public until October 6 (the statutory deadline for the President's determination).

CEA objects to retaliation because Japanese cigarette tariffs are now among the lowest in the industrialized world and U.S. exports enjoy a higher penetration than in other comparable markets and are continuing to gain market share. Moreover, CEA believes that American consumers should not be penalized by retaliation simply because U.S. firms are precluded from directly investing in Japan, an action not prohibited by GATT.